

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Oller Analyst: Marion Mann DeJong Bill Number: SB 38X  
Related Bills: See Legislative History Telephone: 845-6979 Introduced Date: 02/08/2001  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Backup Generator and Related Hook-up Switching Equipment Credit

### SUMMARY

This bill would create a tax credit for the purchase of a generator and related equipment used to produce emergency electricity.

This bill also would amend the Health and Safety Code to allow the use of generators during a stage 1, 2, or 3 emergency energy alert. These changes do not affect the department and are not discussed in this analysis.

### PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to provide an incentive for taxpayers to purchase generators and related equipment used to produce their own electricity during an emergency energy alert.

### EFFECTIVE/OPERATIVE DATE

This bill would become effective on the 91<sup>st</sup> day following adjournment of the special session. The bill specifies that the tax credit would apply to taxable years beginning on or after January 1, 2002.

### POSITION

Pending.

### Summary of Suggested Amendments

Amendments are needed to define "related hook-up and switching equipment," and to clarify the definition of "backup generator." See "Implementation Considerations" below. Clarification is also needed regarding the responsibilities of the State Air Resources Board in administering this credit. Department staff is available to assist the author with amendments to resolve these concerns as well as the policy concerns discussed below.

#### Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

#### Department Director

#### Date

Gerald H. Goldberg

03/09/01

## **ANALYSIS**

### FEDERAL/STATE LAW

Both state and federal laws allow a deduction for all ordinary and necessary expenses of a trade or business, including expenses relating to energy conservation measures. If the expense is a repair to existing equipment that does not extend the useful life of such equipment, it is deductible in the year paid or incurred. If the expense is a replacement and the useful life of the equipment replaced is more than one year or the repair extends the useful life of the equipment, the cost of the item is recoverable through depreciation over the useful life of the equipment.

Both state and federal laws provide various tax credits designed to provide tax relief for taxpayers that must incur certain expenses (e.g., renter's credit) or to influence behavior, including business practices and decisions (e.g., research credits).

Neither state nor federal laws have a credit comparable to the credit proposed by this bill.

### THIS BILL

This bill would create a tax credit equal to 100% of the cost paid or incurred during the tax year for the purchase of a backup generator and related hook-up and switching equipment. The bill directs the State Air Resources Board to administer this credit.

A "backup generator" would be defined by Section 41511.3 of the Health and Safety Code to mean an electrical generator operated for the purpose of providing emergency power to a customer that otherwise purchases power from a utility.

The taxpayer would not be allowed to claim any deductions, including the business expense or depreciation deductions, for any cost of the generator or related equipment for which the credit is allowed.

The credit would not reduce regular tax below tentative minimum tax for alternative minimum tax purposes. Personal Income Tax (PIT) taxpayers could carry forward any unused credit for a maximum of five years. Bank and Corporation (B&C) taxpayers could carry forward any unused credit indefinitely.

### IMPLEMENTATION CONSIDERATIONS

The department has identified the implementation concerns listed below. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

- The term "related hook-up and switching equipment" is not defined. Undefined terms can lead to disputes between taxpayers and the department.
- The definition of "back up generator" seems to be inconsistent with the understood purpose of this bill. The purpose of the credit is to provide an incentive for taxpayers to purchase generators and related equipment to produce their own electricity during an energy emergency. The credit would be allowed for the purchase of a "back up generator," which is defined as a generator operated to provide emergency power to a customer that otherwise purchases power from a utility.

Despite the understood purpose of this bill, the present language could be interpreted to permit the credit for a generator that produces electricity for a person other than the taxpayer claiming the credit.

- Taxpayers and department staff do not have independent expertise in the area of generators and related equipment and thus may have difficulty determining if the equipment qualifies for the credit. Having independent expert verification of the property would help the department in administering this credit.
- The responsibilities of the State Air Resources Board in administering this credit are unspecified.
- The carryover period for unused credit for PIT taxpayers is different than it is for B&C taxpayers. This may cause taxpayer confusion, especially for shareholders in S corporations. The S corporation could carry forward the unused credit indefinitely while the shareholder could carry forward any unused credit for a maximum of five years. This issue can be resolved by making the carryover periods consistent.

## LEGISLATIVE HISTORY

SB 16X, Soto (2001-02 First Extraordinary Session) would create a refundable tax credit for the purchase of a generator used to provide electric service at a dairy farm located in California.

SB 220, Oller (2001-2002) is identical to this bill.

## OTHER STATES' INFORMATION

Although *Florida*, *Illinois*, *Massachusetts*, *Michigan*, and *New York* do not provide a tax credit comparable to the credit proposed in this bill, the following is a brief list of some incentives provided for energy conservation. (The laws of these states were reviewed because their tax laws are similar to California's income tax laws.)

*Massachusetts* has an extensive program of tax exemptions and credits designed to encourage energy efficient systems and alternative energy systems. These tax benefits include the following: individuals are allowed a credit for the purchase and installation of solar or wind energy systems for their residence; and businesses are allowed a deduction for the purchase and installation of solar and wind energy systems for heating, air conditioning, or water heating purposes.

*Michigan* does not generally provide energy conservation incentives through the tax system but uses an extensive system of grant and loan incentives to encourage investment in alternative energy and energy conservation.

*New York* has programs designed to affect both the consumption and the production of energy conservation systems and alternative energy equipment. Individuals are allowed a credit equal to 25% of certain solar electric generating expenditures.

## **FISCAL IMPACT**

If the implementation considerations addressed in this analysis are resolved, the department's costs are expected to be minor.

## **ECONOMIC IMPACT**

### **Tax Revenue Estimate:**

Despite data limitations regarding current levels of generator use for the purpose of emergency power, this bill would result in significant annual revenue losses. As a 100% tax credit, the order of magnitude could be \$2.5 billion annually beginning in 2002-03.

### **Tax Revenue Discussion:**

The revenue impact of this bill would be determined by both the amount of costs incurred by taxpayers for back-up generators and related hook-up and switching equipment and the amount of credits that could be applied to reduce tax liabilities.

Backup generators for residential use range in size and cost from a 3-kilowatt gasoline powered generator for a few hundred dollars up to a 20-kilowatt diesel, propane, or natural gas generator for several thousand dollars. Backup generators for commercial use range in size and cost from a 40-kilowatt size generator for \$10,000 to \$25,000 up to a 1-megawatt or larger generator for more than a hundred thousand dollars. Switching equipment is an additional cost as is the related hook-up. The additional switching equipment and hook-up costs can range from \$1,000 for residential installations to in excess of \$100,000 for commercial installations.

Statistical information regarding the current level of backup generators purchased annually for use in California is not available. There are roughly 6.7 million single family detached residential units and more than a million commercial enterprises in California. If 1% of households and 5% of businesses in any given year incur average costs of \$2,500 and \$50,000, respectively, the potential state revenue loss would be \$2.7 billion.

## **ARGUMENTS/POLICY CONCERNS**

This bill does not limit the credit exclusively to generators or related equipment that are used or installed only in California.

The bill implies, but does not require, that a generator be used during a power emergency. The Health and Safety Code provisions of the bill are related to generators used for emergency power during a stage 1, 2, or 3 emergency energy alert. However, the credit is allowed for the purchase of any generator regardless of when or if the generator is used. Other than possible air violations enforced by the State Air Resources Board, the language would permit taxpayers to use the generator at any time. On the other hand, if the credit were restricted to generators used only during a stage 1, 2, or 3 emergency energy alert it would be difficult to determine when generators were actually used. In addition it could be difficult for taxpayers and department staff to determine that a generator was used on a stage 1, 2, or 3 emergency energy alert during an audit conducted a few years after use.

This bill does not specify a repeal date or limit the number of years for the carryover for B&C taxpayers. Credits typically are enacted with a repeal date to allow the Legislature to review their effectiveness. However, even if a repeal date were added, the department would be required to retain the B&C carryover on the tax forms indefinitely because unlimited credit carryover is allowed. Recent credits have been enacted with a carryover limit since experience shows credits are typically used within eight years of being earned.

The bill does not provide for the recapture of the credit if the generator or related equipment is sold or no longer used within a specified time. Moreover, since the credit is granted at the time the costs to purchase are paid or incurred, it is theoretically possible for taxpayers to resell these generators among themselves to generate multiple credits. That is because there is no mechanism to require actual use for a specified time.

Conflicting tax policies come into play whenever a credit is provided for an item that is already deductible as a business expense or is depreciable. This credit would require an adjustment to reduce basis to eliminate the double benefit of receiving both the credit and the expense deduction or depreciation deduction. However, this adjustment would create a basis difference for state and federal purposes, which is contrary to the state's general conformity policy.

Credits generally are provided as a percentage of amounts paid or incurred. This bill would allow a 100% credit, which is unprecedented.

#### **LEGISLATIVE STAFF CONTACT**

Marion Mann DeJong  
Franchise Tax Board  
845-6979

Brian Putler  
Franchise Tax Board  
845-6333